

The Sources of Potential Financial Instability in Developing Economies

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A Preview

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Introduction

- ◆ The transmission of global financial instability
- ◆ The impact depends on the degree of reliance on foreign demand on exports
- ◆ The impact also depends on the degree of reliance on short-term foreign capital.

Sources Originating Externally

- ◆ Short-term capital flow (portfolio investment (including hot money) and short-term loans other than trade credit). Are the short-term capital inflows necessary? Are the short-term capital inflows beneficial? Foreign direct investment and long-term foreign loans are clearly beneficial and do not cause short-term disturbances in the financial and foreign exchange markets, but not so foreign portfolio investment, short-term capital inflows and short-term loans.
- ◆ High domestic savings rates reduce the need for foreign short-term capital inflows. Should there be some form of a tax on short-term round-trips of foreign capital, as was done in Chile and Switzerland?

Sources Originating Externally

- ◆ Issuance of inflation-protected government bonds in the domestic currencies to provide both the domestic savers (of high savings-rate economies) as well as foreign investors with a credible instrument. Some form of guarantee of the convertibility of the domestic currency proceeds from these bonds can be provided by multilateral agencies such as the Asian Development Bank or from one or more East Asian central banks either individually or collectively. The Asian Development Bank or some other multilateral agencies can also act as a standby buyer in the secondary market.
- ◆ This would enable the development of a bond market in domestic currency and make it unnecessary for the country to try to issue foreign-currency denominated bonds, which require foreign exchange earnings to service and to repay.

Sources Originating Externally

- ◆ Issuance of depositary receipts by domestic publicly listed enterprises to be traded on foreign stock exchanges so as to minimize the necessity of the inflow of foreign exchange. Foreign portfolio investors can invest directly in the shares of domestic enterprises on foreign stock exchange in terms of foreign currency.
- ◆ Foreign direct investors with good bank credit should be allowed to borrow domestic currency domestically for its direct investment, either from banks or through the issuance of bonds. In this way, the foreign direct investor has a natural currency hedge. Its assets and liabilities will be in the same domestic currency and because they are nearly balanced there is no net foreign exchange risk. The foreign direct investor will need to secure the loan or the bonds issued with a guarantee from the parent in the home country, with a standby letter of credit, or with deposits in terms of the foreign currency.
- ◆ Such an arrangement is win-win because the foreign direct investor can minimize its foreign exchange exposure and its financial statements are less subject to the vagaries of exchange rate fluctuations (current accounting rules require marking to market every reporting period). For the host country, the commercial banks will acquire a valuable customer with minimal risk. And no foreign exchange needs to flow into the country.

The Advantages of a High Domestic Savings Rate

- ◆ A country with a high savings rate does not need to rely on foreign savings—does not need to borrow abroad and bear the potential risks of a large, and often interruptible, foreign-currency denominated debt.
- ◆ With new resources being made available each year from new savings, enabling new investments to be made, the necessity of restructuring and redeploying existing investment is greatly diminished (thus making it more possible to avoid creating losers).

The Advantages of a High Domestic Savings Rate

- ◆ Latin American economies are the chronic sufferers of a low domestic savings rate. They are therefore forced to augment their domestic savings by borrowing abroad in foreign currency. But loans have to be repaid sooner or later. When that happens, domestic investment will have to fall below domestic savings, and economic growth may not be sustainable; and in the repayment process currency crises will often result.
- ◆ The low domestic savings rate in Russia made it necessary for Russia to privatize and restructure, a process which resulted in approximately a decade of declining real GDP and the creation of many losers.

Sources Originating Internally

- ◆ Inconsistent and non-robust credit and loan standards and procedures tend to create non-performing loans.
- ◆ High debt to equity ratio—the probability of failure of the borrower is higher, and the potential for contagion to upstream or downstream enterprises is also higher; the payment of increased cash dividends can help to attract more equity investors.
- ◆ Maturity mismatch—the U.S. Saving and Loan Association debacle; fixed rate residential mortgage loans in China are a potential problem because the lenders do not have sufficient long-term fixed rate deposits.
- ◆ Inflation
- ◆ Risk control and management
- ◆ The incentive structure—One must have an incentive structure that does not encourage the assumption of too much risk.

Encouragement of Higher Cash Dividends

- ◆ The government can help by allowing enterprises to deduct actual cash dividends paid to shareholders as a cost just like interest paid to banks on loans, before taxes. This will accomplish a couple of desirable objectives.
- ◆ First, the bias in favor of debt-financing will be removed. Enterprises will no longer find it advantageous for tax reasons to prefer debt financing over equity financing.
- ◆ Second, enterprise income (profit) will no longer be subject to “double taxation”—taxed once at the enterprise level, and again at the shareholder level. Profits paid out as dividends will only be taxed once, at the shareholder level. Moreover, if the government wishes to do so, it can also exempt the first, say, 5,000 Yuan of cash dividends received each year, from individual income taxation, encouraging households to purchase and hold shares for the long term.

Encouragement of Higher Cash Dividends

- ◆ Third, in the case of China, in which the government is the 70% majority shareholder of the publicly listed state-owned enterprises, the gross revenue to the government will actually increase—even as it loses the corporate tax on enterprise profits actually paid out as cash dividends, it gains by the additional cash dividends paid and received by the government.
- ◆ Fourth, if enterprises wish to invest in new projects, it may have to borrow from the commercial banks instead of using its own retained earnings, and hence will be subject to some financial assessment and discipline. It will help to reduce over-investment.

Encouragement of Higher Cash Dividends

- ◆ Moreover, the cash dividends paid provide a floor for the price of stocks. For example, if an enterprise pays 4 Yuan a year as cash dividends, its price is not likely to fall below 100 Yuan (assuming that the rate of interest is approximately 4%). This is a good time to encourage state-owned enterprises to begin paying significant cash dividends, bring the cash yield to the 4% level. This will provide support for the prices of the common stock of these enterprises if and when the stock market bubble begins to burst.
- ◆ Cash dividends are also a good signal of the enterprise's health. Unless it is really making money and has cash flow, an enterprise will not be able to pay cash dividends. Thus, one can falsify the financial accounts and show profits as much as one wants, but one must have real cash flow to pay cash dividends.
- ◆ Finally, cash dividends make it much more attractive for shareholders to hold the stock of an enterprise for a longer period, which is good for the corporate governance of the enterprise.

Maturity Mis-Match

- ◆ Real estate prices have stabilized or begun to decline gradually in many cities in China. However, There is a crying need for longer-term fixed-rate (as opposed to variable- or adjustable-rate) mortgage loans. Long-term fixed-rate mortgage loans allow home-owners and home-buyers the ease of mind as their interest and principal repayment obligations are fixed and predictable over time.
- ◆ However, since commercial banks do not have access or at least do not have sufficient access to long-term fixed rate deposits, they cannot make long-term fixed-rate mortgage loans without assuming a significant risk of maturity mismatch. The U.S. Savings and Loan Association crisis, caused by these lenders lending long and borrowing short, in the early 1980s is a lesson that should be taken seriously.
- ◆ Securitization of qualified standard mortgage loans should be encouraged and promoted, the sub-prime loan crisis in the U.S. notwithstanding. This is the only way to prevent maturity mis-match of a mortgage lender's assets and liabilities.

The Risks of Inflation

- ◆ The key to the control of inflation is to lower inflationary expectation and to prevent it from rising. One solution is for the commercial banks to offer as an option indexed bank deposit accounts, the rate of interest on which is linked to the rate of change of the Consumer Price Index (CPI) during the period the funds are on deposit.
- ◆ Indexed deposit accounts have been previously introduced in China twice--once in 1949 and the early 1950s, and once in 1988 until the early 1990s, both in response to high and accelerating inflation. They both proved to be effective in stopping the flight of bank deposits from the commercial banks and in lowering the expectation of inflation.

The Risks of Inflation

- ◆ But how can domestic commercial banks hedge against the changes in the CPI? Securities similar to the Treasury Inflation Protected Securities (TIPS) issued in the United States by the U.S. Treasury should be introduced. This enables commercial banks to offer indexed deposit accounts linked to the Consumer Price Index (CPI) without assuming the risks themselves. They can simply purchase inflation protected bonds issued by the Ministry of Finance with the funds they have in indexed bank accounts.
- ◆ Real lending rates should be kept from becoming is negative. Negative real interest rates encourage moral hazard and hence indiscriminate and reckless borrowing since the borrower has to repay less in real terms than what he or she has borrowed.
- ◆ The availability of inflation-protected government bonds, alongside with the standard non-inflation-protected government bonds of the same maturity, permits the estimation of the inflationary expectation in the market.

The Risks of Inflation

- ◆ Moreover, once a government issues inflation-protected bonds, it will have an additional incentive to control inflation more effectively—a higher rate of inflation results in a higher costs to service the inflation-protected government debt. Thus, offering inflation-protected government bonds is a signal of the government’s commitment to control inflation.
- ◆ The inflation-protected securities are aimed at domestic investors as much as foreign investors. After all, the domestic citizens have the largest pool of local currency assets. They are also the natural buyers and long-term holders of inflation-protected securities. With the availability of such credible inflation-protected securities, domestic citizens do not need to seek foreign currency assets as a store of value. Thus, the introduction of inflation-protected bonds (and with them inflation-protected bank deposits) will also help reduce capital outflows, both legal and illegal.

Concluding Remarks

- ◆ Integration of the East Asian economies—East Asian economies now trade more with one another than with either United States or Europe. Thus, a slow-down or a recession in the U.S. will have only a marginal impact on East Asian economies, including China.
- ◆ The experience of the East Asian Currency Crisis in 1997 shows that the downturns were sharp when they occurred simultaneously but the upturns were also fast and sharp when all economies recovered together. This shows that the East Asian developing economies as a group can grow independently of the U.S. and Europe.